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Markets In Denial

“We have already seen that for the gold-standard-mechanism to operate in such a way as to preserve internal as well as external balance, there must be a sufficient degree of wage flexibility in the sense that the general level of money wage rates must continuously fall (or rise) so long as there is an excess supply (or demand for) labor in the economy.”

The Balance of Payments, Prof. J.E. Meade, Oxford University Press, 1951

Watching the ever faster booming global financial markets, one wonders about the many wonderful things happening in the real world of the United States and Europe to cause such frenzied bullishness. On Wall Street, high tech stocks soared against the background of a rapidly lengthening list of companies releasing cautious warnings about disappointing sales and impending weakness in earnings. In Europe, the Amsterdam summit made it embarrassingly plain that there is very little on which European leaders can agree. Yet the financial markets took it cheerfully.

The psychiatrists have a phrase for this type of behavior: the patient is “in denial” of reality.

In this letter we again look for the fundamentals that would provide a rational basis for the euphoria in the financial markets, but our evaluation of the facts prevents us from joining the “new era” crowd. Instead, we find more reason for concern, including new evidence of the deceptive nature of record corporate profits; recent data that suggest the U.S. consumer is continuing to spend more and save less; and an odd, growing divergence between the growth of corporate profits and the real growth in national income. But, of course, Wall Street seems not to notice just as it apparently does not notice the precarious shape of major high tech companies — leaders of the market’s current boom, and most probably leaders of its inevitable decline.

In the second half of this issue we look at another case of denial, as we explore in depth the old and new pitfalls on the road to a single currency for EU-Europe. First of all, we explain the reasons that have made us a fierce, fundamental objector. Considering the blatant incapability of the governments of the major countries to cope with their severe home-made economic and fiscal problems, a common monetary policy will not make but break Europe. Our verdict about the politicians and their EMU obsession is scathing. The foreseeable complications were never given the thorough analysis they require. For us, EMU is clinically dead.

UP AND UP

Compared to the economies of Europe and Japan, the U.S. economy is widely seen to be the wonder of the world. President Clinton rubbed it in to his foreign guests in Denver. A growing chorus of pundits, investors and economists argue that for America the good times are here — for good.

Some back-slapping is in order, for sure, when looking at Europe. At issue, in our view, is to what extent some of the spectacular U.S. achievements are the dubious products of a bubble economy. Our attention continues to focus on two sectors that have crucially accounted for the U.S. economy’s outstanding performance: the consumer borrowing and spending binge, and the extraordinary boom in high tech.

Both also make the key difference to Europe — but in reverse. While the American consumer tends to borrow, his cash-strapped European counterpart usually retrenches. Nor do the wealth effects that heavily fuel the current U.S. consumer spending play any role in Europe. Boasting in Denver of his successes, Mr. Clinton might well reflect on the grace that such consumers and such a miraculous stock market have shed on his Administration.

Reports of a weaker U.S. economy and tame inflation have signaled to the financial markets that the highly desired moderation in economic growth is back again. Being convinced that this will also pacify the Fed, there is nothing left to hold the markets back. While the credit markets have rallied modestly, the readily excitable stock market has risen spectacularly. Most sentiment indicators show an extreme level of bullishness, reflecting a general sense that this boom is reasonable and by no means extraordinary.

Well, after an amazing three-year run in the equity markets, one can easily become insensitive to the magnitude of the rally experienced over the past two months. With the gains from their lows in late April, the Dow and the S&P 500 now have year-to-date gains of more than 20 percent. A ten percent increase, by the way, equates to almost one trillion dollars of additional market capitalization — or more than ten percent of GDP.

Much to the relief of the bulls, even the small caps have come to life. The Russell 2000 has staged more than a 15 percent rally, bringing its year-to-date gain to over eight percent. But while narrowing its dramatic underperformance, the twelve-month gain of 14 percent remains unimpressive in comparison to the 38 percent rise in the Dow and 36 percent for the S&P500. Even the NASDAQ composite now holds a year-to-date gain of 12 percent, but no less than four-fifths of the advance came from just four stocks. While the number of advancing stocks has certainly increased, the overall performance remains remarkably narrow. Make no mistake, this market is led and completely dominated by the large caps.

Inarguably, the dramatic run in large caps has driven their valuations to unprecedented levels. Four stocks considered absolute core holdings for all investors and fund managers attest clearly to the excess: General Electric, Coca Cola, Microsoft and Intel have recorded 12-month gains of 60 percent, 50 percent, 110 percent and 115 percent. Combined, these four companies now have market capitalization of an eye-opening \$675 billion. GE trades at almost 30 P/E and three times revenues, Coke at 48 P/E and nine times revenues, Microsoft at 53 P/E and nine times revenues, and Intel at more than 60 P/E and nine times revenues — notwithstanding its recent warning of a sequential decline in quarterly revenues.

On average, the S&P 500 now sells at almost 23 times earnings and a dividend ratio of only 1.65 percent while the NASDAQ 100 trades at a lofty P/E ratio of 52 and a dividend of one-tenth of one percent. An investment firm recently had an advertisement in the WSJ that certainly captured the current mood by stating that their clients “could sleep well at night” knowing that their fund’s largest holdings were GE, Coke, and Microsoft. The markets have certainly made it to the point where literally no price is too high to pay for a good night’s sleep.

RATIONAL EXUBERANCE?

All financial bubbles have one single cause: unduly loose money, reflected in excess credit and a collapsing demand for money creating the illusion of an unlimited supply of capital. But in order to generate the necessary boom atmosphere, also required are supporting “theories” that specifically justify exceptionally high asset prices. Without fail, such crackpot theories are sure to crop up and to be eagerly seized upon.

In the case of stock market bubbles, these “theories” are at bottom always alike. Their regular main components are the end of inflation, low interest rates and permanent superior corporate profit growth. Since

inflation and interest rates can't fall forever, profits become in the long run crucial. If stock prices are not to end up at completely random, astronomic levels, they intrinsically need permanent, extraordinary profit gains. Just that is, indeed, Wall Street's core bullish argument, tracing it summarily to the miracles of restructuring.

The truth is that the profit picture of Corporate America has become rather checkered since early last year. Yet stock prices have continued to forge ahead, taking all kinds of valuation-gauges to highs never seen before. At the same time, it is reported that professional investors and advisers have turned rather wary. Where, then, is all that buying power on Wall Street coming from?

According to the Fed's Flow of Funds Accounts, there are three groups of big net buyers: corporations (buybacks and cash-financed mergers), life insurance companies, stock mutual funds and state and local Government Employee Retirement Funds. Together, they pumped last year nearly \$300 billion of new cash into the U.S. equity market. Does that explain the bull market? Hardly, because there was virtually equivalent net selling by two groups: private households (\$245 billion) and private pension funds (\$39 billion).

Individuals thus diminished their direct share holdings far in excess of their increases in holdings through mutual funds. Presumably, this has two main reasons. A massive shift into mutual funds and the rapidly escalating creation and sales of stock options related to the compensation of management and employees. Taken together, these figures hardly offer a satisfactory explanation of the continuing, exceptional boom in U.S. stocks. Who, then, rules Wall Street? ... Frenzied derivatives trading, we guess.

Actually, the bulls never bother about such a boring question as the possible source of all the money pouring into the stock market. It's simply there. For most of them, their market "research" consists of just successively raising their bets in step with the stock indexes. When the Dow hit 6,000, they predicted 7,000, and after that mark too was hit, they just moved on to 8,000 and higher. They are satisfied to rehearse their pet story of the arrival of a new era of a permanently low inflation rate, in which peerless U.S. management boosts profits forever by means of cost-cutting.

True to this spirit, Wayne Angell, former Federal Reserve governor and now chief economist of Bear Stearns, posed in a recent WSJ article under the heading "Rational Exuberance" the question, "Will the Dow reach 10,000 in 1999?" His answer: "My guess is yes. But it depends on the economic policy environment."

He leaves no doubt what he means by that: no rate hike by the Fed, persistent loose money. And he explains why: In this stable-money era of Mr. Greenspan, any rise in interest rates is superfluous because people and markets nowadays always act and react in a perfectly disciplined way. U.S. consumers have rediscovered the value of savings, and balk at high prices for goods. The corporate CEO has a new focus — cutting costs. Equity fund managers look for such exemplary companies and reward them with high stock prices. Those who fail end up with lower P/E ratios, confronting their managers with the loss of their jobs or lower bonuses and stock-option benefits. A truly perfect world, in which central banks might as well abdicate.

Not for the first time, Mr. Wayne entertains us with his eccentric theorizing. Yet this piece seems his most stupendous. The worth of his reasoning is indicated by his remark about savings, which flies in the face of reality. Probably correct, however, is his statement that output and spending have been substantially understated during the last two years. The Commerce Department is, indeed, to publish this July statistical revisions that will reconcile a record discrepancy between the higher income gauges and the spending and output gauges of recent years. Being the two sides of one and the same coin, product and income growth should be identical.

U.S. ECONOMIC GROWTH EVEN SEEMS UNDERSTATED

In the available statistics, real incomes have over the last two years risen at a 3.7 percent annual rate, as against 2.9 percent annual gains in real GDP. Exceptionally sharp rises in income tax receipts suggest that the higher income-side measure is more correct. That's why the revisions are expected to bring mainly higher GDP growth, showing it even more robust than had been realized.

For Mr. Angell, this is nothing but good news, as it inherently implies higher productivity gains and lower labor unit costs for these two years. Unfortunately, unmentioned by him, this good news has a less palatable flip-side, and that is a virtual collapse in the personal savings rate, probably to below three percent of disposable income. So much for the idea that the "U.S. consumer has rediscovered the value of savings."

The discovery of still higher consumer spending and the essentially associated sharp decline of personal savings simply confirms that the run-up in stock prices and the realization of capital gains has had a substantial effect on the economy — the typical destabilizing bubble effect. It appears possible and also logical that the resulting wealth effects have been gaining in strength: the more they grow, the longer they last.

THE ACHILLES HEEL: PROFITS

We have always regarded business profits as the Achilles heel of Wall Street's bull run. With long-term growth of nominal national income of five to six percent, long-term double-digit growth of profits is simply impossible. With this point in mind, we have always had a wary eye on the flow of profit figures. As to be expected, Wall Street readily ascribed the profit surge in the 1990s to the "new era" of corporate restructuring, apparently justifying its long-run extrapolation.

As we detailed in our 1996 September and October letters, the profit miracle of the 1990s had an utterly different origin. In the three years up to the end of 1993 it stemmed in full from the steep fall of corporate interest costs. These declined over this period by \$89.5 billion, compared with a simultaneous \$85.7 billion profit gain. Without the grace of Mr. Greenspan it would have been a profit disaster.

Since we never shared the Wall Street profit illusions, we also never shared its euphoria about the earnings-driven stock market boom. As the effects of the interest windfall dissipated in 1994, this inherently implied sharply weaker future profit growth. In the national income accounts, business profit growth did, in actual fact, slow drastically to near-stagnation in the course of 1996. In hindsight, though, we have to admit that we had grossly overestimated the markets' vigilance and rationality, while grossly underestimating the combined proficiency of Wall Street and corporate management to delude the public about underlying profit trends.

Trying to penetrate the statistical fog surrounding U.S. business profits, the first requirement is to distinguish between the profit figures derived from the GDP and national income account and those reported by the companies. In their desperate attempts to impress the markets and to fatten their bonuses or the value of their stock options, corporate managers have developed great adeptness at manipulating their accounts or at putting reported profits, at any rate, into a favorable light. Take note: first quarter 1997 reported profits were up a spectacular 15 percent, but against a meager three percent gain for the profits of the national income kind.

An evident way to boost future earnings is the popular strategy of writing off large amounts for restructuring or costs acquisitions. Wall Street first rewards the write-offs as signs of effective restructuring, and later it rewards the apparent higher profits. Certainly the simplest way to raise earnings per share is to reduce their outstanding number by buybacks. While Wall Street likes to trumpet this "valuable" use of strong cash

flow, we see it more and more in connection with weakening earnings. A glaring example in this regard is IBM. Central to the market's climb have also been consistently better-than-expected profits, a lot of them due to prior company-guided downward revisions of expected profits.

No such manipulations are possible with the profit figures derived from the national income account. Yet, they too have for many years been considerably embellished by means of the huge capital gains reaped by corporate pension funds in the financial markets. As a result, funding through corporate contributions is for many years now virtually non-existent — to the benefit of corporate profits. Only recently, we have learned of another distortion in U.S. corporate profits that has in the last two years erupted. It concerns the rapid expansion of stock options as an instrument to attract talent and to remunerate management and higher-level employees. The recognition of its importance came in April 1996, when mysteriously soaring personal non-withheld income tax payments took the IRS by surprise. Extensive investigations identified one main source: stock options (cf. Laura Jeverski, *WSJ*, May 13, 1997). For 1996 and 1997, tax receipts were underestimated by a staggering \$75 billion.

As a company's stock price rises, employees start to exercise stock options, buying stocks from the company at below-market prices. As a rule, they owe ordinary tax on these capital gains — the difference between the market value of the stock and the option's exercise price. But although the companies have had no expense in this regard, the option gains of their employees are treated as employee compensation, a tax-deductible expense.

In reality, such compensations take place through diluting the equity base. The salient point to see is that this increases corporate profits in two ways: first, by shifting wage and salary costs out of the profit-and-loss account and to shareholders; and second, by providing the corporations in addition with a tax credit for something they never paid. Yet, thought footing the bill, shareholders appear happy. Indeed, by inflating corporate profits, it helps to inflate stock prices. Considering that option-related employee compensation soared to roughly \$70 billion pre-tax in 1995, this gives an idea of the magnitude of the resulting profit overstatement. It ought to surface with the impending GDP revisions.

Does it matter for the markets? Probably not in the foreseeable future. For the time being, this is a market that simply ignores anything negative. True, it tells us that the excesses in U.S. stock valuations are a lot worse than we had thought. But, as we mentioned earlier, all asset bubbles have one and the same cause: an overabundance of credit and money chasing assets, in this case financial assets.

For us, this is lunacy, but who really cares about fundamentals or valuations, as long as there is an apparently unlimited global supply of credit and money for financial speculation, much of it heavily leveraged. Chasing yields in the bond markets and momentum in the stock markets, regardless of risk, is the only respected game in town. The signs of progressive credit and money overabundance are all over the global financial markets. In the stock markets it shows in the ever-higher valuations, and in the bond markets in the collapse of yield differentials.

As we have stressed in earlier letters, the central banks have lost control. Deregulation and globalization have brought financial structures into existence that create credit and money both inside and outside the banking system in complete independence of the central banks. At the same time, the massive shift towards securitization has completely removed the former constraint through bank capital ratios. Once a bank hits that limit, it simply securitizes a part of its loans.

All this is allowed to continue without a trace of monetary restraint because the central banks are conventionally supposed to tighten only when the price indexes for goods and services rise. But, given the global sluggishness in economic growth, these traditional triggers of monetary tightening are no longer forthcoming — even though unbridled asset inflation has gone global with a vengeance. Be it the wild

speculation in China or Hong Kong, the aggressive return of investors to Mexico and Latin America, the love affair with Russian stocks or bonds, or the extraordinary gains experienced this year in Europe, financial markets everywhere appear over-stimulated and speculative in character.

EXTREMELY IMBALANCED U.S. ECONOMIC GROWTH

Turning back to the question of U.S. economic growth, few people seem to realize its grossly imbalanced composition. Its dominant features are consumer spending and high tech. Consumption hit in the 1990s an all-time high of 68.6 percent of GDP, compared with 65.4 percent in the 1980s and 57 percent in the 1970s. In the language of the Austrian school, such a trend has the bad name of capital consumption. Still more phenomenal was the rise in equipment investment, accounting for 24.5 percent of GDP growth in this period, as against 9 percent in the 1980s. It seems an exceedingly positive factor, except for the fact that it was virtually all computer- and information-related, what may in hindsight prove an unsustainable bubble.

In recent letters, we have said, keep your eyes on high tech news and high tech stocks. That remains fully valid. High tech was in many ways crucial to the extraordinary performance both of the U.S. economy and the stock market. It has been central in creating the "new era" image; it strongly bolstered the profit aggregate; it contributed out of proportion to output and GDP growth; and its steeply declining prices were crucial in lowering the U.S. inflation rate. The fortunes of the technology industry and technology stocks have become vitally important to both the U.S. economy and the stock market as a whole.

Notwithstanding accumulating news of sharply weaker demand for high-tech products, customary bullishness prevails. Meanwhile, the list of companies releasing negative views is most impressive in both its length and composition: Intel, Hewlett Packard, Gateway 2000, NCR, Seagate Technologies, Micron Electronics, Cabletron, Adobe, Packard-Bell, NEC, Circuit City. Embracing PCs, disk drives, networking, and software, this list is clearly indicative of broad-based deterioration. Yet Wall Street has remarkably succeeded in calming investors with the mantra that any problems are "company specific," and that for new high tech opportunities one needs simply to "look across the valley." It may yet take some time, until we definitely know of what kind this slowdown of the technology sector is. Common sense, after all, would say that this spectacular high tech boom has temporarily been hyper-stimulated by some specific circumstances and that it must essentially slow down from its exorbitant growth rates.

EMU — THE EMPEROR HAS NO CLOTHES

French governments come and go, yet French international aspirations always stay the same. While the new Socialist government has caused broad consternation with its new stipulations for accepting the Euro Pact, nobody can say that they represent a break with the policies of past French governments on this subject. They are really old wine in old bottles. Ever since the common currency has been in discussion, these very same demands have ranked prominently in French intentions.

During his electoral campaign, Mons. Lionel Jospin repeatedly listed five conditions for France joining EMU:

- 1) EMU must include Italy and Spain from the start;
- 2) economic growth and job creation should be made the EU's top priority;
- 3) further fiscal austerity measures are for France out of the question;
- 4) the euro must not be overvalued against the dollar or the yen;
- 5) the European central bank must be counterbalanced by a "European economic government."

Add to this set of French EU demands the archaic Keynesian-style promises dished out to the domestic electorate, prominently among them the creation of 350,000 government jobs for younger people, and the reduction of the workweek from 39 to 35 hours without loss of pay. Considering on the other hand how easily the Bundesbank, backed by public opinion, defeated the German chancellor's fiscal fudging attempt, the two events strikingly highlight what a chimera the Franco-German consensus on the Euro really is. In the same vein, Europe's politicians demonstrate in one conference after the other their outstanding skill in beguiling their electorate with ambiguous formulations that pretend agreement, while the underlying differences, although large, remain in reality unsolved.

Superficially, it has often appeared that in the Maastricht Treaty and riders German strictness prevailed over French liberality. The truth is that the French negotiators have generally succeeded in inserting provisos that make the established provisions virtually toothless. A spectacular case of this kind is the German-inspired Stability Pact that is supposed to assure fiscal discipline after the common currency has been implemented. Germany required virtually automatic sanctions to be imposed on countries that run deficits in excess of three percent of GDP. But yielding to pleas by president Chirac, Mr. Kohl averted a breakdown on the issue by consenting to a compromise that made the whole Stability Pact a virtual farce by stipulating that the imposition of any fine would be subject to approval by two-thirds of the weighted votes of EMU countries, excluding the country considered.

It is our long-held view that Mr. Kohl would stop at virtually nothing to achieve the common currency for Europe, however soft it may finally turn out. More than any other politician in Europe, he has his name tied to the realization of EMU. Explicitly, we refer to his name, not his future, because the days of Mr. Kohl as Chancellor of Germany are in any case numbered. His coalition government with a paltry ten-seat parliamentary majority is bound to lose the election in October 1998. Unfortunately for Mr. Kohl and EMU, this election will take place just six months after the EU has decided over wide or narrow EMU membership. The public domestic outcry in response to the fudging attempt with the gold revaluation gives a little foretaste of the tempest that will follow a definite EU ministerial decision in favor of a general fudging of the Maastricht criteria.

Most importantly, two prominent politicians — Mr. Stoiber, premier of Bavaria and leading figure in the government coalition, and Mr. Schroeder, Social Democratic premier of Lower Saxonia — insist on absolutely strict interpretation of the Maastricht criteria. What's more, both are leaving no doubt that, if necessary, they will apply to the German Constitutional Court. This would essentially give tremendous political weight to such a plaint, quite apart from the fact that public utterances by the likely judge in the responsible division of the Court reveal a highly critical attitude. Being anyhow the most popular politicians in Germany, they know perfectly well that their rigorous stand against any watering down of the Euro conditions is sure to add considerably to their clout. Together, the two might well lead the next federal German government, embracing CDU and Social Democrats.

We have opposed EMU right from the beginning for a variety of reasons, both political and economic. As an economist with a bias to do our own thinking, we have always realized that the monetary integration of a dozen sovereign countries with very different economic structures and traditions is an endeavor fraught with immeasurable consequences and risks. We find it impossible to believe that the politicians who are frantically pursuing the project have given the necessary careful thought to possible and probable negatives. In Germany, Mr. Kohl is notorious for his total lack of interest in and knowledge of economics. If German unification testified to his political acumen, the desolate state of German public finances seven years later testifies to his grossly lacking qualities as a manager of the economy.

HIDDEN DISSENT FROM THE START

It is a widely quoted fact that the people in Europe are disgruntled with their political class as never before. Indeed, they register a staggering discrepancy between frenzied activity and high-sounding pretensions on the European level and utter immobility and ineptness on national levels. Ironically, the worst examples in both respects — feverish Euro-activity versus domestic paralysis — are France and Germany. While playing the political “locomotives” for European Union, their economies have turned into Europe’s “lame ducks.”

As to ourselves, we have to say that since the Bosnian holocaust, which these politicians did more to foster than to stop, our doubts about their qualifications as competent leaders of Europe has definitely turned into outright contempt. We simply feel unable to identify ourselves with their “Europe”, and that is probably true for many other people.

The present difficulties affect whether EMU can start on schedule. But the far more important issue, of course, is whether it will work smoothly and efficiently thereafter. In public, the arguments in favor of the Euro have oscillated from the promise of economic benefits to its importance as a pacesetter for a future united, federal Europe. In reality, the politicians of all the twelve countries that signed the Maastricht treaty had from the start very divergent views about what it meant, and what they intended for their own country, the Germans and French in particular. In other words, the very concept of EMU was born with strong, hidden, internal dissent.

Nevertheless, it has always been our basic assumption that EMU’s political success will crucially depend on the economic development that will follow its enactment. If, for whatever reason, employment and incomes grow satisfactorily, everything will be okay. But woe will betide the common currency and Europe’s political harmony if the ensuing economic development seriously disappoints. That, unfortunately, is the safest thing to predict, given Europe’s deep-seated structural problems, which are fostering ever higher unemployment.

Then, for sure, the Euro will not make Europe, but break Europe — regardless of whether or not it is truly the specific culprit. In most countries, notoriously except Germany, it has been tradition to make the central bank and its monetary policy responsible for any economic adversities. It doesn’t need great insight or foresight to anticipate that under EMU the common central bank will inevitably become the regular scapegoat for any economic troubles.

A CRUCIAL DEFICIENCY

In the case of EMU, it would even have a certain justification. The salient thing to see is that a common monetary policy, implemented by the European central bank, will be the one and only macro-economic tool available within the area. To be noted: one currency means one single monetary policy for the whole area, though in a dynamic modern economy the size of the United States or Europe there are bound to be significant regional differences in economic performance

With exchange rates locked within the union, something else has to give when economic adjustment is needed. Fiscal policy, by contrast, will principally remain under national discretion. Governments can spend and tax as they like, but the Stability Pact designed to keep public spending under control, restricts the size of budget deficits. If truly adhered to, this would leave little room for reflationary policies. Thus, our earlier statement that monetary policy will be the only macro-economic tool available within the area.

In the absence of flexibility in exchange rates and fiscal policy, alternative mechanisms are needed to stabilize regional economies. These are wage flexibility, labor mobility and fiscal transfers. While the U.S. economy possesses the first two in abundance, in Europe both are completely lacking. Already Schumpeter

called the Americans nomads. In Europe, the combination of cultural and linguistic differences and still powerful trade unions makes in both respects for extraordinary rigidity.

And now to an aspect of monetary policy that is generally ignored or neglected: the essence of monetary policy is one single short-term interest rate across the whole area — no more, no less. Given money rates today in the EU countries of between 3.1 percent (Germany) and 6.35 percent (Italy), the European central bank would have to choose one single rate covering all member countries, regardless of divergent business cycles. More than any great theorizing, this simple consideration illustrates one of the most obvious snags in shaping a common monetary policy. Essentially, it implies repeated legitimate conflicts of interest between countries in different cyclical conditions, not to speak of the irreconcilable fundamental differences in the national perceptions of a strong or soft Euro. The potential for conflict and mischief is truly frightening.

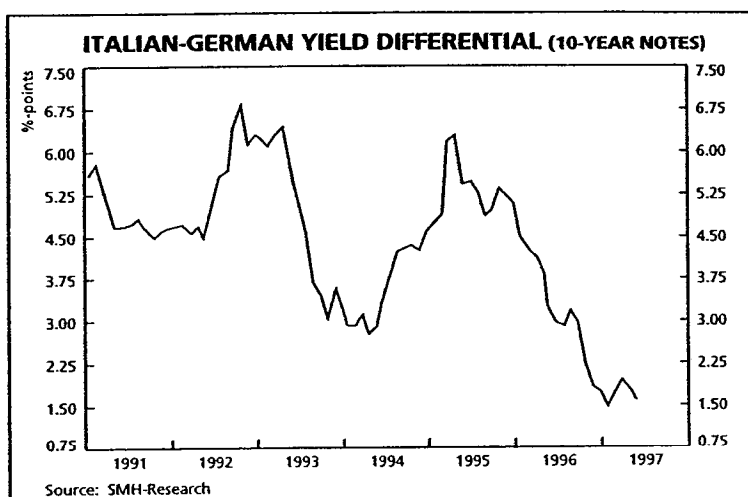
We could fill many more pages with our objections to EMU. But observing the prevailing euphemism in the financial markets, the most pressing question at the moment is evidently the likelihood of its punctual start on January 1, 1999. Oddly, according to current reasoning, the recent events have not derailed the EMU train, but rather seem to have made the financial markets all the more confident that EMU will proceed on schedule, and with Italy in the founding group. Lucid indicators of this general denial of looming trouble are the weak D-mark and the persistently narrow German-Italian yield spread.

AN ABSTRUSE EMU LOGIC

We don't share this complacency at all. It has an abstruse and contradictory logic. On the one hand, it is argued that through his own ill-guided attempt to manipulate the value of Germany's gold reserves Kohl has implicitly lost the moral authority to oppose the financial trickery of other countries to join the EMU club. For sure, this is correct. Utterly absurd, however, is the further conclusion that this speaks for EMU because it shows Mr. Kohl's iron will to impose it on the unwilling German public. Apparently, his savvy and power to achieve EMU are taken for granted. In the rush to monetary union, popular sentiment in Germany apparently counts for nothing. Who, by the way, can seriously think that this is the proper way to a united Europe and that it is a great politician who tries to achieve this end in this way?

The opposite is true. Essentially, Kohl's international loss of influence and credibility has its domestic parallel. While his failed gold coup may appear to many foreign observers a minor lapse, it was in the German environment a truly fatal mistake. By doing this, Mr. Kohl and his finance minister shattered their key argument that the strict application of the entry criteria would ensure a European currency as hard as the D-mark.

This never made sense, but the dogged insistence of German politicians on absolutely strict interpretation and fulfillment of the Maastricht criteria served two purposes: first, it gave their promises of a hard euro a modicum of credibility; and, second, it tended to defame any opposition as being nationalistic, the last thing a German wants today to be accused of. Now, by virtually abandoning the entry criteria with his own foul action, Mr. Kohl has not only opened the spigots of unrestrained criticism from the euro-phobes but also shocked and silenced the crowd of bona fide euro-philés. The first striking result in this respect is the public criticism by Bavaria's premier, Stoiber.



There is, by now, general agreement that virtually none of the leading countries of the EU will meet the required criteria for participating in Europe's single currency. In its just published semiannual Economic Outlook, the Organization for Economic Cooperation and Development (OECD) says it expects France, Germany and Italy to post budget deficits of 3.2 percent of GDP this year, thus exceeding the three percent Maastricht limit, though by a very small margin. Other countries, including Spain, Belgium, the Netherlands and Portugal, will make the grade on the budget deficit but are likely to fall short on the debt criterion, which requires governments to bring their debts down to 60 percent of GDP.

THE OECD RECOMMENDS OVERALL FUDGING

Yet the prestigious international organization urges the European countries rather to abandon the criteria than to back off from their currency plan, because postponement would be far more damaging than going ahead using the original criteria, which would initially exclude some countries. "From an economic point of view, it would seem rather anomalous to exclude countries from EMU on the basis of two-tenths of a percentage point in terms of their budget deficit," according to the OECD's acting director in a press conference.

Admittedly, it may appear preposterous to let a grand political design be wrecked by such minuscule misses of the criteria. But who truly believes in a grand design, considering the otherwise dismal policy record of these politicians? Moreover, these low numbers, presented by the OECD, tacitly imply considerable cheating. Another necessary consideration in weighing the deficit criterion is the fact that a limit of three percent of GDP is already generous by historical and international standards. Major countries outside the EU, such as United States, Canada and Australia, have slashed their formerly very high budget deficits to below two percent of GDP, regarding it as an imperative to economic health. Japan has also taken drastic measures towards achieving that objective, without being subject to the Maastricht treaty.

Oddly, the OECD makes its blanket recommendation to abandon the criteria without any idea of whether or not the new French Socialist government will deliver on its generous campaign promises. It is not unusual that politicians backtrack on campaign promises. President Chirac did so in an almost scandalous way. But Mr. Jospin has been too explicit in his promises of economic goodies to be able to retreat altogether. He has to deliver some part of it, and that as fast as possible if only for one reason: Chirac will be tempted to call new elections (after a minimum of 12 months) as soon as he thinks the right can win again. That means the Socialists will have to act in an attempt to stimulate the economy enough to have a chance to retain power. In the absence of fudging, the French budget deficit will rather hit four percent of GDP.

THE TWO MAJOR EMU PITFALLS IN GERMANY

Even more astounding to us is the general complete disregard of the two major pitfalls that are looming in Germany on the road to EMU. No doubt, Kohl is determined to override the overwhelming hostility in public opinion. Yet it perplexes us how many people in democratic nations don't take any offense at such blatant, imperial self-righteousness by a politician.

Admittedly, the German electorate has, just by itself, no chance to abort EMU. Despite the hostile public opinion, the ratification of the Maastricht Treaty by the German parliament was backed by 96 percent of the vote. What's more, the present leader of the Social Democrats, Lafontaine, even openly condemns the deficit criterion and supports many French demands, including the subordination of the European central bank to a political body. In this light, Lafontaine is Germany's Jospin, only much less sympathetic as a person. Thus, Kohl's modest reelection chances next year lie in the reasoning that he is the lesser evil compared to Lafontaine.

In this light, the markets are undoubtedly right in their belief that the German political class will ultimately

defy public opinion and also defy its own former categorical claims that the criteria must be strictly interpreted and fulfilled. Yet this overlooks the two decisive hurdles existing outside parliament — the Bundesbank and the German Constitutional Court.

While the Bundesbank does not participate in the final EU ministerial decisions, it is involved in the preparations for the decision-making through the European Monetary Institute (EMI). This is commissioned to examine in March of next year the fulfillment of the various criteria. Since the institute is governed by the heads of the national central banks, we confidently expect honest, critical appraisals not only from Mr. Tietmeyer but from the institute's majority. They can't make themselves the accomplices of the cheating politicians. In addition, the EU Commission will also produce new budgetary projections for 1998. According to its findings, the institute will then have to make recommendations about the EMU eligibility of the various countries.

As stressed in its last annual report, the monetary institute will make the sustainability of the results a main consideration, essentially implying that one-off measures and accounting tricks will not be sanctioned. From this standpoint, Italy, in particular, has no chance. True, the verdict of the central bankers is not binding for the politicians, but disregard by the politicians would create another disastrous impression.

A different case in this respect is the second German hurdle on the road to EMU: the Constitutional Court. From what we read in the international press, we can only conclude that the markets grossly underestimate the power and the probability of a negative verdict by this Court which would bind the German government. One of the comforting arguments is that the Maastricht Treaty allows for some flexibility. Perfectly true, but the flexibility is explicitly made contingent upon a sustained declining trend in the budget deficit or debt level of a country over the past years. Neither France nor Germany, however, qualify in that sense for any leniency, as their deficits have risen. (See the table on page 12).

The first thing to see is that the Constitutional Court in Karlsruhe in its preliminary ruling in 1995 had stipulated that both houses of the German parliament would have to approve the transformation of the DM into the euro, and that the conditions in the treaty would have to be met strictly. If they were not, the parliamentary vote would be open to legal challenge. As already mentioned, just that is the declared intention of the premier of Bavaria, who is facing regional elections next year. In turn, the key justice on the Court, Paul Kirchhof, reaffirmed in October 1996 that "only numbers," not politics, would be weighed in judging whether the DM should be surrendered.

EUROPE'S FISCAL AUSTERITY IS A MYTH

Hearing all the lamentations about the fiscal austerity that is depressing Europe's economy, our first response is that German and French fiscal policies have not at all been restrictive in the past years. In both countries, government spending has in these years soared as a share of GDP. While German politicians like to exonerate their fiscal mess with the high costs of unification, the spending spree that resulted is nevertheless the precise opposite of fiscal restraint. Europe's problem, and in particular that of France and Germany, is fiscal profligacy that chokes economic growth. Significantly, quite a few smaller countries that have successfully slashed their budget deficits, like the Netherlands, Ireland, Denmark, Sweden and Portugal, are enjoying stronger growth.

Last but not least, these dismal budget and debt data put the lie to the widespread perception that Europe's growth and employment problems are attributable to fiscal restraint. Such talk only serves to distract attention from the true causes, lying chiefly in over-generous welfare systems, excessive taxes and rigid labor markets. It goes without saying that the introduction of the Euro contains nothing that would tend to remedy these internal, structural maladjustments plaguing the European economies.

For all the fine words in Amsterdam, the single currency project looks more fragile than ever. By proffering the French a fig-leaf in the form of some platitudes about a renewed focus on growth and jobs, the

hidden fundamental rift between French and German policy conceptions has burst to the surface. Yet bond markets continue blithely to trust this circle will be squared. Quite how remains a mystery.

The fact is that with their endless fiddles and dirty compromises the EU politicians have already seriously discredited their common currency, long before it comes into existence. The very rules that were presented as essential to assure a stable currency have been casually jettisoned as soon as they proved inconvenient.

If governments do this in flagrant defiance of existing strict rules even before EMU is enacted, just imagine what liberties they might take once their membership is secured. The consequences for the common currency as for the European Union as a whole would be disastrous if German politicians are allowed to gamble away the international respect that Germany has earned for its economic rectitude when it is most needed.

Considering that the lira and peseta climbed after the Amsterdam summit, as investors obviously continued to bet on a "wide" and soft Euro, even though France had yielded to German insistence on the stability pact, one realizes how much Mr. Kohl has discredited himself. The reasoning is that France may have lost a battle, but that it is sure to win the real war over the soul of Europe. No doubt, Mr. Kohl will lose the war, though not against France but against the Bundesbank and the German public. There will be no Euro.

CONCLUSIONS

Every time, the Fed's repeatedly expected rate hike fails to happen, the U.S. stock market takes another leap. Although U.S. economic growth has been stronger than we had expected, we regard the two sectors that mainly account for it, consumer spending and high tech, as being vulnerable to a strong reversal.

Just as before, we see nothing but a seemingly endless period of global monetary looseness ahead. By the logic presently prevailing in the markets, this would imply a continuing stock market boom, even though most valuations are already in outer space. As in all great speculations, it is futile to guess when and how this bubble will end.

For the time being, there are two foreseeable hazards: in the United States big profit disappointments, and in Europe the bursting of EMU. Both would come completely unexpected.

GOVERNMENT DEFICITS, DEBTS & EXPENDITURES

All as a percentage of nominal GDP

	Deficits		Debts		Expenditures	
	1990	1996	1990	1996	1990	1996
United States	2.7	1.6	55.6	65.0	32.8	33.3
Japan	2.9	4.4	65.1	88.0	31.3	3.6.2
Germany	2.0	3.9	43.8	60.5	45.1	49.6
France	1.6	4.1	35.4	56.5	49.8	54.1
Britain	1.2	4.8	35.3	56.0	39.8	41.6
Italy	11.1	6.8	98.0	124.5	53.4	53.4
Netherlands	5.1	2.4	78.8	78.5	54.1	50.0
Spain	4.1	4.5	45.1	70.0	42.0	43.1

Sources: 67th Annual Report, Bank for International Settlements;
OECD Economic Outlook

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